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No. 83-1792

In the Supreme Court of the United States

OCTOBER TERM, 1984

HOOVER & BRACKEN ENERGIES, INC., PETITIONER

v.

UNITED STATES DEPARTMENT OF THE INTERIOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Secretary of the Interior's method of calculating royalties for gas produced from federal and allotted Indian lands is prohibited by the Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.*

2. Whether the Secretary's method of royalty calculation is based on an arbitrary and capricious interpretation of 25 C.F.R. 172.16 (1981) and 30 C.F.R. 221.47 (1982) and is otherwise contrary to law.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A13) is reported at 723 F.2d 1488. The opinion of the district court (Pet. App. E1-E7) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on December 28, 1983. A petition for rehearing was denied on February 3, 1984 (Pet. App. G), and the petition for a writ of certiorari was filed on May 3, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The State of Oklahoma imposes two severance taxes on natural gas produced within the State: a gross production tax of 7% of the gross value of the production of natural gas (Okla. Stat. Ann. tit. 68, § 1001(b) (West Supp. 1983)), and an excise tax equal to .085% of the gross value of

all natural gas produced within the State subject to the state gross production tax (*id.* § 1102). Both taxes are required to be paid to the Oklahoma Tax Commission by the purchaser of the natural gas, who is authorized to deduct the taxes paid from the payments due to the producer and/or royalty owner (*id.* §§ 1009(d), 1102). The royalty share of the natural gas produced from federal and restricted Indian lands is exempt from both the gross production tax and the excise tax (*id.* § 1008 and *id.* § 1106 (1966)).[1]

The Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3301 *et seq.*, establishes ceiling prices for all natural gas produced and sold in the United States (with the exception of certain categories of high-cost gas not at issue in this case). Section 110(a)(1) of the NGPA, 15 U.S.C. 3320(a)(1), permits the applicable ceiling price to be exceeded to the extent necessary to recover "State severance taxes attributable to the production of such natural gas and borne by the seller * * *."

2. Petitioner is an independent producer of oil and gas and holds interests as lessee in several oil and gas leases of federal and allotted Indian lands in western Oklahoma. These federal and Indian lands have been communitized with privately-owned lands.[2] Petitioner's leases of

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[1]Thus, if the federal government were to own a royalty interest of ⅛ of the natural gas produced from its leasehold, the purchaser would pay severance taxes on ⅞ of that production. See Pet. App. D4.

[2]Under the government-approved communitization agreements, all land included within one drilling and spacing unit, as established by state law, is developed as though the land were under one lease. Communitization allows production from one well within the unit to constitute production from each lease within the unit. Costs are borne by each lessee according to the percentage of the total acreage in the unit leased, and production from the unit is allocated to each lessee and royalty owner-lessor in accordance with the terms of the lease. See Pet. App. A9 n.5, D3, E4.

non-Indian federal lands provide that a royalty of 12-½% on production shall be computed pursuant to 30 C.F.R. 221.47 (1982),[3] which provides as follows:

> The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

The leases of allotted Indian lands incorporate 25 C.F.R. 172.16 (1981),[4] which provides for a royalty of 16-2/3% of the "value" of the natural gas produced, as determined by the Secretary of the Interior:

> During the period of supervision, "value" for the purposes of the lease may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or

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[3]This regulation has been redesignated as 30 C.F.R. 206.103 (1983).

[4]This regulation has been redesignated as 25 C.F.R. 212.16 (1983).

> actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary of the Interior, be deemed mere evidence of or conclusive evidence of such value.

Petitioner sells the natural gas produced from the communitized units under long-term contracts that require the purchasers to pay petitioner the applicable NGPA ceiling price and to pay directly to the State Tax Commission all state severance taxes levied on the gas. Petitioner paid the royalties due under the federal and Indian leases based on the NGPA ceiling price it received for the gas, without including in the royalty calculation the state severance taxes paid by the purchasers.

3. By letter dated June 14, 1979 (Pet. App. B), the Area Oil and Gas Supervisor (the Supervisor) of the United States Geological Survey (USGS) notified petitioner that royalty payments must be based on the "gross value" of the gas sold, and that "gross value" includes the taxes paid by the purchasers; the supervisor demanded payment for past and future royalties calculated accordingly. Petitioner's initial appeal of the Supervisor's determination was denied by a tribunal composed of the Acting Director, USGS, and the Acting Deputy Commissioner, Bureau of Indian Affairs (Pet. App. C1-C6).[5]

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[5]The administrative tribunal relied on the decision of the Interior Board of Land Appeals in *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973), which established that "value" for royalty computation purposes

Petitioner then appealed to the Interior Board of Land Appeals (IBLA), which affirmed the previous administrative determinations (Pet. App. D1-D11). Recognizing that "the Secretary of the Interior has considerable latitude in determining what is the 'value' of production from a lease on which royalty payments are made" (*id.* at D6), the IBLA rejected the argument that the value of production, for royalty computation purposes, could not include the amount of severance taxes paid by the purchasers. The IBLA noted that "the NGPA expressly allows a price for the gas to be set above the maximum lawful amount to the extent that it reflects state severance taxes paid" (*id.* at D7; emphasis omitted). Although it recognized that under Oklahoma law, it is the purchaser, rather than the seller, who pays the severance taxes to the State Commission, the IBLA pointed out that the state law permits the purchaser to deduct the severance taxes from the amount paid to the seller. Accordingly, the IBLA concluded (*ibid.*) that

> [petitioner] has the same ultimate responsibility for the taxes and receives the same benefit under Oklahoma's method of tax collection as it would in a state where the seller is obligated to pay the taxes directly and benefits from reimbursement by the purchaser. Here [petitioner] still receives the benefit of "tax reimbursement" and consequently the value of that benefit may be added to the amount [petitioner] receives to determine the value of production to [petitioner] for the purpose

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includes the amount of the severance tax paid by the buyer to the seller. Although noting that the taxes involved in this case are paid by the buyer directly to the state tax commission, the tribunal concluded that this is not a relevant distinction, reasoning that "[t]he payment of the tax by the buyer inures to the benefit of the seller because [petitioner] '* * * does not have to reach into its own pocket to pay the severance tax liability' " (Pet. App. C5-C6, quoting from *Amoco Production Co.*, 29 I.B.L.A. 234, 237 (1977)).

> of computing the royalty. As reported by [petitioner], the amount it receives under its contracts is the NGPA ceiling amount. Since under Oklahoma law a purchaser must deduct the amount of taxes paid to reach the purchase price, we assume that such price reflects the deduction of that amount and therefore the value to [petitioner] of the gas in this case is the ceiling amount plus the tax paid by the purchaser.

4. Petitioner filed this action in the United States District Court for the Western District of Oklahoma, seeking judicial review of the IBLA decision. The district court granted petitioner's motion for summary judgment (Pet. App. E1-E7, F). The court noted that under the NGPA, "the maximum lawful price of natural gas may be exceeded to the extent that state severance taxes are *borne by the seller*" (*id.* at E7; emphasis in original). It concluded (*ibid.*): "To the extent that the United States interprets its regulations in a manner designed to place a value upon its share of the production that is in excess of the maximum lawful price, such interpretation is contrary to the expressed provisions of the law."

The court of appeals reversed (Pet. App. A1-A13). It held that the IBLA's earlier decision in *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973), which was decided under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, and which upheld the inclusion of tax reimbursements as part of the value of production for royalty computation purposes, was not rendered inapplicable by the enactment of the NGPA (Pet. App. A4-A8). In this regard, the court pointed out that Section 110(a) of the NGPA, 15 U.S.C. 3320(a), allows the statutory ceiling price to be exceeded to the extent necessary to recover state severance taxes (Pet. App. A8). The court concluded that the Secretary's decision to calculate the value of production on the basis of the NGPA ceiling price

plus any severance taxes paid by the purchaser is consistent with the statutory scheme of the NGPA (*id.* at A10).[6]

ARGUMENT

The decision of the court of appeals upholding the Secretary's determination of value of natural gas production for royalty computation purposes is correct and, this case being one of first impression, does not conflict with any decision of this Court or any other court of appeals. Accordingly, review by this Court is not warranted.

1. Petitioner argues (Pet. 7-12) that the Secretary's method of royalty calculation is inconsistent with the ceiling price and severance tax reimbursement scheme established by Congress under the NGPA. The Secretary has required that the amount of severance tax "reimbursed" to petitioner from the purchasers be taken into account in calculating the value of the natural gas produced for royalty computation purposes.[7] Petitioner apparently concedes (Pet. 8 n.13) that the NGPA would not bar a producer and a private lessor from entering into an agreement for calculating royalties on the basis of the total value of the production, including the NGPA ceiling price plus any state severance tax reimbursement. Petitioner contends (Pet. 10),

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[6]Judge Seth dissented (Pet. App. A11-A13). He concluded that, because the state severance tax is paid by the purchaser directly to the state and not to the producer, the tax has no relation to value (*id.* at A13).

[7]As noted above, Section 110(a) of the NGPA, 15 U.S.C. 3320(a), permits producers to charge in excess of the applicable ceiling price in order to recover state severance taxes borne by *the seller*. Under Oklahoma law, however, the severance taxes are paid directly by the purchaser, who is entitled to deduct those taxes from the payments due to the producer and/or royalty owner. The IBLA correctly concluded (Pet. App. D7, D9) that the fact that the purchaser is liable for payment of the tax does not alter the economic result. Thus, the Oklahoma severance tax scheme is the economic equivalent of the more typical tax reimbursement system permitted by Section 110(a) of the NGPA. Petitioner does not appear to dispute this point.

however, that "[w]here a portion of tax reimbursement costs * * * is appropriated by a tax exempt royalty owner, it is clear that the statutory purpose in allowing the ceiling price to be exceeded under Section 110 is thwarted." This contention is without merit.

One of the primary purposes of the NGPA was the "establishment of a statutory incentive price structure that would simultaneously promote production and reduce the regulatory burden * * *." *Public Service Commission* v. *Mid-Louisiana Gas Co.*, No. 81-1889 (June 28, 1983), slip op. 11. Title I of the NGPA defines eight categories of natural gas production and specifies the maximum lawful price that may be charged for "first sales" in each category. *Mid-Louisiana Gas Co.*, slip op. 2. Section 110(a) of the NGPA provides that a seller who includes in his price an amount necessary to recover state severance taxes "shall not be deemed to have exceeded the federal price ceiling if he would not have exceeded it had that amount not been included." *Exxon Corp.* v. *Eagerton*, No. 81-1020 (June 8, 1983), slip op 7.

The NGPA, however, does not expressly address the issue of royalties. And there is nothing in the Act or its legislative history that suggests that the government, as lessor of gas-producing properties, may not assign, as the value of production for royalty purposes, the maximum NGPA ceiling price plus the amount of tax reimbursement paid by the purchaser for gas produced from government leaseholds. The only relationship between the NGPA's incentive pricing scheme and the Secretary's royalty calculation method is that petitioner pays royalties to the government out of the proceeds it receives from the sale of gas, which proceeds include the severance tax reimbursement. Of course, every royalty payment decreases the amount of net proceeds and thus lessens the incentive to

produce and sell gas. But it does not necessarily follow that such royalty payments are thereby subject to challenge as being contrary to the congressional policy underlying the NGPA.[8]

At bottom, petitioner's argument appears to be that the Secretary's royalty calculation method is somehow "unfair" because it permits the government to benefit from the tax reimbursements paid on the portion of the production in which the government has no royalty interest (see Pet. 15-16). But there is nothing in the NGPA that prevents the government from collecting a royalty on the total value of the production from its leasehold. Although the government's royalty interest (like the interest of a private royalty owner) is set at a fixed percentage of production, the NGPA does not require the "value" of that production to be determined by looking only to the percentage of production in which the government (or private royalty owner) has an interest. On the contrary, the royalty may be based on the "value" (in this case, the NGPA price plus any tax reimbursements) of *all* the gas produced from the leasehold.

2. Petitioner also argues (Pet. 17-20) that the Secretary's interpretation of his own regulations (25 C.F.R. 172.16 (1981) and 30 C.F.R. 221.47 (1982)) in determining the value of production for royalty computation purposes is arbitrary, capricious and unreasonable because it produces different results depending on the identity of the seller, the

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[8]We note that this is not a case in which the royalty owner has sought to impute a value to the gas for royalty purposes at a level exceeding the maximum lawful price applicable to that gas. See Pet. App. A6. Thus, there is no need for the Court to hold this case pending its disposition of the petitions for a writ of certiorari in *Ashland Oil, Inc.* v. *Good*, No. 83-1234; *Mobil Oil Corp.* v. *Batchelder*, No. 83-1248; *Kewanee Oil Co.* v. *Holmes*, No. 83-1250; and *Cities Service Oil Co.* v. *Matzen*, No. 83-1278.

tax jurisdiction in which the lands are situated, and the percentage of federal or restricted Indian lands included within the producing unit.

It is well settled that, to sustain an agency's construction of a term in a statute it administers, a court need not find that the agency's construction is the only reasonable one, or even that it is the construction the court would have chosen had the question first arisen in judicial proceedings. See *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, No. 82-1005 (June 25, 1984), slip op. 4-7. Moreover, "[a]n agency's construction of its own regulations has been regarded as especially due [considerable] respect." *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 566 (1980). See *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965).

The leases of both federal lands and allotted Indian lands involved in this case provide that the Secretary or his delegate shall establish the value of production for royalty purposes. The leases also incorporate the applicable regulations for federal and Indian lands, which list the various factors the Secretary should consider in determining the value of production. It is clear that the Secretary's royalty calculation method is sanctioned by the regulations. With regard to federal lands, the Secretary is given broad discretion to consider not only the gross proceeds received by the lessee, but also "the highest price paid for a part or for a majority of production of like quality in the same field" as well as "other relevant matters." 30 C.F.R. 221.47 (1982).[9] The Secretary's method of calculating royalties based upon the gross proceeds received by petitioner for gas produced from (or attributable to) the government leaseholds — *i.e.*,

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[9]The leases of Indian lands and 25 C.F.R. 172.16 (1981) contain similar language, and petitioner has not contended that the federal and Indian leases should be construed differently.

the applicable NGPA price plus severance tax reimbursement — is a reasonable application of the regulations at issue. Indeed, as the IBLA pointed out (Pet. App. D10-D11):

> inasmuch as the regulation clearly requires that "gross proceeds" serve as the minimum basis for the royalty assessment, the only alternative method would be to ignore "gross proceeds" and proceed on the assumption that all production was subject to severance taxation to determine the value of the gas produced. This would, necessarily, work to the detriment of every Federal oil and gas lessee.

Petitioner contends (Pet. 17-18) that the Secretary's method is arbitrary and unreasonable because, if the government were to take "in kind" its royalty share of gas produced from its leasehold and then sell it, it could receive only the NGPA ceiling price by virtue of the fact that its interest in the production is tax-exempt. This argument, however, assumes that the "value" to the United States of "in kind" gas is necessarily equivalent to the price it could command upon the sale of that gas. This assumption was correctly rejected by the IBLA (Pet. App. D9):

> If, however, the Government were to take its royalty interest in kind, the implicit assumption would be that it had a use for the gas. The value of this gas is, therefore, properly computed as the price which the United States would pay on the open market if it were purchasing the gas as an ordinary purchaser.

The price the government would pay to receive gas of like quality to "in kind" gas in the present case would include both the NGPA ceiling price and the state severance tax.

Petitioner also contends (Pet. 18-20) that the Secretary's method is arbitrary and capricious because the total amount of royalties due the lessors in a communitized unit

will vary according to the tax jurisdiction in which the lands are situated and the percentage of federal or Indian land within the unit. In both situations, however, the differences in royalty are the direct result of the tax-exempt status of the federal and Indian royalty interest in the gas (see Pet. App. D9-D10).[10] The immunity from state taxation is a function of federal sovereignty and, as such, is a benefit that should accrue to the government. As noted by the IBLA, "[t]he fact that the United States cannot be assessed state severance tax does not depreciate the *value* of the gas to it" (Pet. App. D9; emphasis in original).

In sum, when petitioner leased the federal and Indian lands at issue, it agreed that the Secretary would have the discretion to determine the value of natural gas production for royalty purposes. The Secretary's method of royalty calculation constitutes a reasonable exercise of that discretion.

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[10]The percentage of Indian or federal land within a given communitization unit is determined by the land needed to drill an oil and gas well and is beyond the control of the Secretary. The government collects royalties only on the production allocated to the federal or Indian land within the unit; accordingly, the tax exempt portion generally remains constant as a percentage of the production so allocated, the only variation occurring as a result of different royalty rates in the federal or Indian leases. The lands needed for a communitization unit and the applicable royalty rates are standard elements of doing business in the oil and gas industry and are not unique to Indian or federal leases.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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